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C O N F I D E N T I A L SECTION 01 OF 04 ADDIS ABABA 001842

SENSITIVE
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DEPT PASS TO USTR FOR AMBASSADOR KIRK
NAIROBI PASS TO AMBASSADOR KIRK

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TAGS: ECON EAID ETRD PGOV PREL ET
SUBJECT: SCENESETTER FOR USTR AMB. KIRK'S VISIT TO ETHIOPIA

Classified By: Political/Economic Section Chief, Michael C. Gonzales fo
r reasons 1.4 (b) and (d).

SUMMARY

¶1. (C) Your visit to Addis Ababa comes at a challenging time for the Ethiopian economy. The economy is punctuated by a chronic -- and largely endogenous -- macroeconomic imbalance and the government and ruling party's dominance over most economic sectors. The global economic downturn has only exacerbated the economy's own challenges. Average inflation stands at 36 percent -- the second highest in Africa, after Zimbabwe. Despite two rounds of devaluation of the Birr by 10 percent each this year, the real exchange rate remains overvalued. Foreign exchange reserves stand at nearly two months of import coverage -- a significant improvement from six months ago -- that stems from an imposed stranglehold over lending to the private sector. Real interest rates remain strongly negative. Power-shedding due to inadequate electricity generation capacity over the past three months has forced manufacturing and a significant portion of business activity to slow to a stutter. While AGOA exports have more than doubled since last year, to $18 million, the bulk of these are in the "leading sectors" which the Ethiopian Government (GoE) has endorsed and liberalized. Broader exports have stayed flat, despite projections of 25 percent growth. With exports of only $1.5 billion compared to nearly $7 billion in imports, Ethiopia's trade imbalance is dire and growing.

¶2. (C) With over 100 state-owned enterprises and a roughly equivalent number of ruling party-owned enterprises, incentives facing GoE officials are heavily skewed against allowing competition, particularly foreign competition, in the economy. Ethiopia is sincere in its desire to accede to the World Trade Organization (WTO), but is not willing to forego state-dominance of the telecommunications or financial services sectors. The GoE is counting on riding its "seventh least developed country in the world" status to guilt WTO members to refrain from demanding liberalization of these sectors despite the clear bottleneck their restrictions pose to broader economic growth or expanded trade. We strongly urge you to deliver a clear message to the GoE that, while we applaud Ethiopia's growth in AGOA exports, the United States is concerned that Ethiopia's openings to investment and export growth have been restricted largely to specific sectors. We encourage you to press the GoE to expand investment incentives and adopt attractive policies to draw

investment to new export sectors as well as those geared toward domestic consumption. We also urge you to convey a clear message to the GoE that we will be looking for a clear, specific, and expeditious plan from them on the opening up of the telecommunications and financial services sectors as they pursue WTO accession. End Summary.

GENERAL OVERVIEW OF THE ECONOMY

¶3. (SBU) Ethiopia remains one of the poorest countries in the world. In 2008 its Gross Domestic Product (GDP) was approximately USD 25.7 billion, with per capita GDP of USD ¶324. Chronic cycles of drought, high population growth, state and ruling party dominance in numerous commercial sectors, inefficient agricultural markets, and ever increasing power outages all act to limit Ethiopia's economic development. The agricultural sector comprises 45 percent of GDP and employs 85 percent of Ethiopia's 79 million people. Although Ethiopia's economy is relatively small, it is growing at a fast pace. The GOE publicly touts that Ethiopia has experienced double-digit real GDP growth of over 11 percent in recent years. The GoE predicts real GDP growth of 10 percent this year. Many institutions, including the World Bank and IMF, dispute the GoE's growth statistics, stating that Ethiopia's real GDP growth rate will most likely range between six and seven percent this year.

¶4. (SBU) Total exports have increased over 20 percent per annum on average in the past five years. Total exports this year, remained flat over last year's level of $1.5 billion.

Coffee exports -- Ethiopia's major export earner -- are down 25% from last year. The GoE blames coffee exporters (who were allegedly hoarding supply) for the decline in exports and as a result, revoked licenses of six major exporters, detained some company owners overnight, closed the warehouses of over eighty firms, and confiscated their coffee stocks to export directly from the GoE. Despite historical export growth, the country suffers a severe trade deficit year after year. Imports totaled USD 6.8 billion in 2008, creating a trade imbalance of USD 5.3 billion. Ethiopia mainly imports machinery, fuel, and consumer goods.

AN ECONOMY BASED IN IDEOLOGY...

¶5. (C) The GoE continues to be guided by the ideological foundations of the ruling party's sister organization of the 1980s, the Marxist-Leninist League of Tigray. Senior ruling party officials continue to cite the obligation of the government to establish the conditions for the manifestation of a workers' class from among the peasantry that will be able to guide Ethiopia to become a middle-income country. The ruling party certainly views itself as a vanguard party whose agricultural-industrialization led development model must be driven by the state. As a result, Ethiopia has over 100 state-owned enterprises (SOEs) involved in virtually every sector from agricultural inputs, to cement, to fertilizer, to condominiums, to wheat importation. As with interest rates, the state intervenes actively to ensure that commodity prices remain -- to the extent possible -- within an acceptable band. Where prices exceed acceptable limits, SOEs intervene to import commodities and dump these on the local market to suppress prices.

¶6. (SBU) While the agricultural-industrialization led development model is optimally suited for an economy like Ethiopia's, following the model of the vanguard party, the GoE alone has selected the "leading sectors" in the economy. These are: 1) hides, skins, and leather; 2) pulses and oilseeds; 3) floriculture and horticulture; 4) textiles; and 5) coffee. In these sectors, the GoE has liberalized significantly: inviting foreign investment; offering attractive investment incentives; and generously allocating

land, credit, and support. As a result of opening up such sectors -- which are geared toward increasing exports and foreign exchange -- these sectors generally have flourished. Whereas each new investor in these sectors continues to enjoy robust incentives and support, investors interested in doing business in other sectors, businesses focused on domestic demand, or even entrepreneurial investors in new sectors continue to be impeded by near-constant bureaucratic obstacles to doing business in Ethiopia. In many cases, sectors are further restricted to Ethiopian investors, and in some, to the GoE only. As a recent sign of potential diversification from the leading export sectors, GoE officials have begun to mention applying import substitution theory as an alternative means to reduce the trade deficit and increase foreign exchange reserves.

...AND PRACTICALITY

¶7. (C) While the GoE's formal dominance over the economy is apparent, the ruling party's heavy role in the economy remains largely in the shadows. Roughly 100 businesses throughout Ethiopia are under the control, and pay dividends to, the ruling parties. Formally registered as companies under an umbrella endowment, these companies have no formal linkage to the ruling parties. Still, the leadership of the endowment is appointed solely from the top echelon of the ruling party's politbureau and party central committee members represent the chairmen and boards of directors of each company. These endowments, or party-statals, are just as diversified as the SOEs -- and just as protected. Endowment companies are the dominant entities in sectors such as transportation, retail, travel services, and construction materials. Along with SOEs, they are also dominant among breweries, cement factories, tanneries, and banks. These party-statals are estimated to have a combined paid-up capital of between $500 million and $1 billion. Credible

reports abound from throughout the private sector of preferences granted to these party-statals in terms of access to credit, access to restricted foreign exchange, access to berths at and trucks from the port, awards for government tenders and contracts, and other preferences that further impede the success of the broader private sector.

A FUNDAMENTAL MACROECONOMIC IMBALANCE

¶8. (SBU) Against this ideological foundation, state control, and skewed incentives, it is no surprise that the Ethiopian economy faces a fundamental macroeconomic imbalance. By mandating low interest rates, and representing the dominant borrowing force in the country, for years the GoE has ensured cheap credit for itself through highly-negative real interest rates. By so enabling excess demand and accommodating it with excess liquidity, Ethiopia has seen a spike in inflation for the past three years. Year-on-year inflation peaked in August 2008 at 64 percent. While last year's high prices have limited year-on-year inflation now to single digits, the 12-month average inflation rate remains at 36 percent. The reluctance of the GoE to adjust its fixed peg exchange rate to accommodate this inflation has resulted in a real exchange rate that was as much as 40 percent overvalued in late-2008. The external imbalance which this induced brought foreign exchange reserves to a perilously low level of two weeks of import coverage. The resulting crisis forced the GoE to seek IMF assistance and advice. Two rounds each of 10 percent devaluation of the Birr (against its U.S. dollar peg) have helped re-build reserves, but have come only on the eve of IMF Board votes on assistance to Ethiopia.

¶9. (SBU) The exogenous global commodities price shock of 2008 exacerbated Ethiopia's endogenous economic crisis. While the GoE has become more forthcoming with IMF and World Bank officials in opening its books, it is clear that the GoE is

more willing to meet nominal macroeconomic targets through false growth figures and further strangling the private sector than in fundamentally addressing the ideologically-driven policies that have caused the fundamental imbalance. To suppress inflation and re-build foreign exchange reserves, the GoE imposed a credit cap on all banks in May, limiting lent-out capital to levels prevailing on the day of the directive. Despite promises to permit the repatriation of profits, the central bank does not allocate adequate foreign exchange to commercial banks to effect such hard currency payments. To stand by its pledge of keeping deficit spending at zero, the GoE initiated a fierce crack-down on the private sector to expand state revenues. National and foreign enterprises alike have been given previous-year tax bills of up to tens of millions of dollars after secret "desk audits." Some of these come after firms had already been audited for the tax year being audited. Finally, with the growing international scrutiny over the government's books, the GoE and SOEs are increasingly turning to China for soft loans and awarding Chinese firms with lucrative contracts -- including many which are sole-sourced, non-competed contracts for major infrastructure projects. American firms routinely complain that Ethiopia's government monopoly telecommunications system is inconsistent and inadequate and the absence of international banks only exacerbate the disincentives to invest posed by bureaucratic and state-imposed impediments.

HOW YOU CAN HELP

¶10. (C) The GoE routinely relies on its "seventh least developed country in the world" status to challenge donors to withhold benefits that would normally be contingent on policy reforms. This strategy has largely served the country well with donors consistently providing greater aid amounts despite structural economic (and political) imbalances. We encourage you to emphasize to GoE officials that while the U.S. looks to strengthen bilateral relations and build our trade links, we also will look to the GoE to adopt appropriate policy reforms to which we hold the rest of the world -- particularly when it comes to WTO accession. You may consider noting that while we applaud Ethiopia's growth

in AGOA exports, the United States is concerned that Ethiopia's openings to investment and export growth have been restricted largely to GOE-identified "lead sectors." A message from you encouraging the GoE to expand investment incentives and adopt attractive policies to draw investment to new sectors that could fill domestic demand as well as offer opportunities for export would re-emphasize similar messages from academic advisors and the World Bank. We encourage you to convey to the GoE that the U.S. will be looking particularly for a clear, specific, and expeditious plan from them on the opening up of the telecommunications and financial services sectors as they pursue WTO accession. Separately, you may consider taking advantage of your media roundtable to challenge the business community to echo these same messages in their engagements with the GoE.
GONZALES